NEXUS

Portfolio Management & Financial Counsel

THE NEXUS REPORT

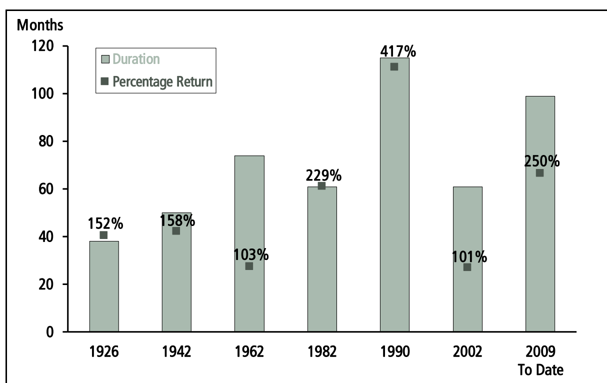
Second Quarter, 2017

A Tiring Bull Market?

After a great run in stock markets around the world, June provided a sobering reminder that markets do not go up endlessly. The TSX Composite provided a modest negative return in June, and remains one of the weakest stock markets in the developed world in 2017 after having been one of the best in 2016. And after a strong start to the year, U.S. stocks as well as stocks in developed international markets and those in emerging markets all generated significant losses in June when measured in Canadian dollars. Admittedly, much of this pullback was the result of the sharp increase in the Canadian dollar (up 6% since the May low), but June was a more sombre month for foreign markets even in local currencies.

Notwithstanding sloppy trading in the last month, investors still enjoy great returns over the last year. Canadian stocks are up 11.0% on a total return basis. Outside Canada things were even better as the S&P 500 in the U.S. generated a total return of 17.6%, developed international markets (EAFE) a return of 20.0%, and emerging markets a return of 23.4% (all in Canadian dollars). More significantly, 5-year returns on all these indexes remain strong and, in most cases, well above long-term averages.

While June's softness may prove to be a wobble in an ongoing bull market, there is no doubt the current bull market, which started in 2009, is getting "long in the tooth." Despite our constructive outlook for the economy detailed below, stock market corrections are inevitable at some point. The chart below shows how the current bull market in U.S. stocks stacks up against the seven best in the last century. It's impressive!



Bull Market Duration and Returns since 1926[1]

Better Times in Canada

The Canadian economy continues to defy the skeptics and show surprising strength. Most recently, the June employment report indicated 45,300 new jobs were created – significantly better than expected – and another drop in the unemployment rate. The details of the report revealed that the employment of prime-aged workers (25-54) hit its highest level since 2008, and even hard-hit regions like Alberta showed a modest improvement in its job situation after the devastating effects of the oil price collapse. Total job creation of 350,000 new positions over the last year is remarkably strong considering the funk that the Canadian economy was in a year ago. Perhaps as icing on the cake, the Bank of Canada's recent Business Outlook Survey indicated that future hiring intentions are at their highest level in the survey's history.

The healthy job market is just one aspect of Canada's economic momentum in 2017. The recent April GDP report showed an impressive 3.3% year-over-year increase, and Canada's GDP growth is widely expected to be the strongest among G7 nations this year. Even our trade situation has improved noticeably with three straight months of non-energy export growth. And the recent purchasing managers' index confirmed the message of the Business Outlook Survey – that there is widespread optimism among Canadian businesses. The recent strength in the Canadian dollar is a sign that investors perceive the outlook for our economy is improving.

Regular readers of the Nexus Report are surely waiting for the usual caveats to all this good news about the Canadian economy. Indeed, there are several today, just as there always are. Wage growth remains surprisingly subdued in the context of an otherwise strong labour market. The average worker's wages are barely keeping pace with inflation. Real estate prices also continue to be the topic of many cocktail party conversations, and the red-hot Toronto housing market gives the impression it may have peaked. Time will tell. Time will also reveal how Canadians deal with the mountain of debt they have accumulated, which is at an unprecedented multiple of disposable income.[2] The same strength in the Canadian dollar that reflects investor admiration of our economic success will present a clear headwind for export industries in the period ahead. And the biggest risk of all is from the rise of U.S. protectionist sentiment and the re-

[1] Source: JP Morgan Asset Management.

[2] However, debt is not as high when compared to household assets as Fergus Gould pointed out in his recent blog.

negotiation of NAFTA, which is so crucial to our economic well-being. While we do not expect a terribly negative outcome from any of these risks, any one of them could present a challenge to the positive economic momentum Canada now enjoys.

Synchronized Global Growth

Just as in Canada, the U.S. labour market posted a surprisingly strong increase for June. The addition of 222,000 new jobs was considerably better than the 178,000 expected. Additionally, job growth in the prior two months was revised higher by 47,000. While the official unemployment rate rose slightly, this was the result of a sharp increase in the workforce, another positive indicator.

Labour market strength has been at the core of the current U.S. economic expansion, which enters its 97th month in July. Amazingly, this is now the third longest economic expansion since the Civil War.[3] However, at the same time the U.S. economy impresses with its durability, the subdued rate at which it has grown remains underwhelming. 2017 growth is expected to be considerably slower than in Canada. The core rate of inflation has fallen in recent months to a level lower than the Federal Reserve would like, and consumer spending is tepid. If there is good news in this slow-growth trajectory, it may be that the current expansion can keep going for a long time yet.

Thankfully, the rest of the world seems to be in pretty good shape as well, and the prospect of synchronized global growth is real. In a recent research piece, National Bank economists detailed several positive dynamics that are driving broad-based economic momentum around the world.[4] Specifically, 95% of surveyed countries are experiencing home price growth, with the median house price up 6.7% in the last year. This wealth effect, combined with strong labour markets and low energy bills, has propelled global consumer confidence to the highest level in a decade.

Risks That Won't Go Away

While there are many reasons to be optimistic about the prospects for global economic growth in the quarters ahead, many of the risks we have discussed before just won't seem to go away.

Making almost daily headlines is the ongoing dysfunction of the U.S. government where the bitter partisan divide in Congress shows no signs of abating. Since the failure of the first attempt at healthcare reform, Americans have become significantly more skeptical that the Trump administration will achieve any substantive policy goals in the near term. As well, questions about the Trump team's possible collusion with Russia in influencing the election grow by the day and add to the sombre mood in Washington.

Britain has started down the path of Brexit which, from the start, seemed like an adventure into the abyss. However, the recent election disaster Prime Minister Theresa May suffered raises an even bigger question about Britain's future relationship with Europe. Elsewhere, we seem to be no closer to a solution in Syria, and the threat that North Korea poses to the world is real, and growing.

Investment Outlook

Hopefully, the comments above have illuminated the great conundrum faced by investors. Economic conditions are good and supportive for corporate earnings growth, but the risks threatening a period of stable growth are unsettling. Moreover, the current extended bull market gives some a fear of heights, and all agree that a market correction is inevitable some time in the future.

So what is one to do? We believe the right answer is to change nothing. Our approach is focused on considering what *could happen*, since we never can know what *will happen*. This means identifying high quality companies that will thrive in good times but also can withstand the shock of the unexpected. The prices of these stocks will go down when the next correction occurs. But they usually go down less than others and they are usually the first to recover when conditions improve. So long as investors have the right asset mix and stick with their financial plan, these temporary setbacks pose no long-term threat. In fact, they often provide good opportunity.

[3] For the curious, the longest expansion started in 1990 and lasted 120 months – exactly 10 years.

[4] Hot Charts, National Bank Financial, July 4, 2017.

Asset Class Investment Review

Fixed Income

For most, but not all, of the second quarter the bond market behaved in the quiet manner that it had displayed since the start of the year. Daily volatility was subdued, meaning prices fluctuated in very small ranges, and most of the activity that did occur was driven by new issuance in the corporate and provincial sectors. If there was any trend, it was for rates to drift slightly lower.

In the background, the global economy continued to move ahead, as yet without producing early signs of price inflation. This is especially true in Canada, where inflation is tracking well below the Bank of Canada's inflation target of 2.0%.[5] Despite evidence that Canadian economic growth is gaining traction, the bond market has been well comforted by Governor Poloz's repeated messaging concerning:

- risks to the recovery due to external uncertainties (code for U.S. trade policies, and fluctuating oil prices),
- risks posed by domestic imbalances (code for high debt levels and soaring home prices), and
- the benefit to Canada's external competitiveness which tolerates a weaker rather than stronger loonie.

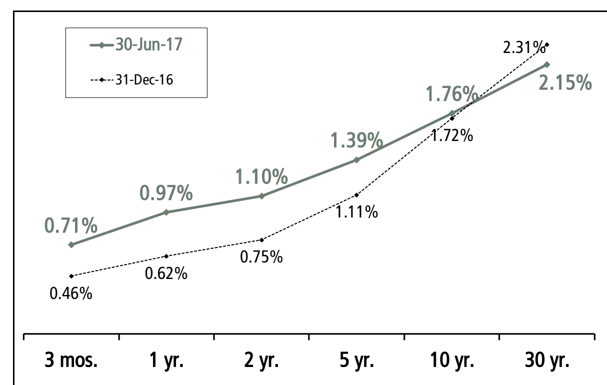
This was the case expressed by the Bank when it released its Monetary Policy Report in April and this narrative was supported by speeches from other Bank officials over much of the balance of the quarter.

However, this all changed in mid-June when Senior Deputy Governor Wilkins acknowledged that Canadian economic growth was broadening, both by industry and geography. She went on to conclude that there was significant monetary stimulus in the system that would be addressed in their upcoming meeting on July 12th. As a result, yields in the Canadian market began to rise and then moved sharply higher at the end of the month when Governor Poloz stated in an interview on CNBC that previous interest rate cuts had," done their job".

We have long expected this general move higher in rates (lower prices), and thought we were well prepared. Unfortunately, market weakness was concentrated in the 2-year to 7-year area of the curve where we are heavily invested and prices of longer-maturity bonds have been less affected. In June, 5-year yields rose 0.45%, 10-year yields rose 0.34% and long bonds only 0.10%. In the year to date, despite an increase in 5-year rates of 0.28%, long bond yields have fallen 0.16% (see graph). As a result, relative to the index we measure our performance against, our performance has disappointed.

The mid-term area of the market, where our investments are concentrated, now anticipates a large degree of future central bank tightening. On the other hand, longer maturities (longer than 10 years) seem artificially low to us and have room to increase. As the economy grows, the labour market tightens and wage pressures heat up, we think the yields of longer maturity bonds will move higher – at least as much as the 5-year or 10-year sectors have already adjusted. For now, we maintain our shorter maturity approach, concentrated in higher quality credits.

In the second quarter, our portfolio declined 0.3%, while the FTSE TMX Universe Bond Index (the Bond Universe) returned 1.1%. In the last year, our portfolio has declined 0.1% as compared to the Bond Universe's return of 0.0%.



Government of Canada Yield Curve

Equities

The markets in the second quarter of 2017 declined slightly, a change or pause from the seemingly endless strong run that started in March 2009. As an indicator, the market benchmark for the Equity Fund in the last 3 months was down 0.6%. The Fund itself outperformed in the quarter, up 0.8%. It continues to have an extraordinary return over the past 12 months, up 19.6%, and was well ahead of the

[5] On June 23rd, Statscan reported headline CPI Inflation of 1.3%.

benchmark's 13.5% return.[6] At this point, we expect that future equity returns will be lower than recent returns.

For the quarter, all asset classes held by the Fund were positive. While our Canadian and U.S. stocks were barely up (both up by less than 1.0%), both were ahead of their respective benchmark indices. Our international equity holdings carried the day, so to speak. EQIT was up 4.3% and EMEC was up 3.6%.

The Canadian dollar surprised almost everyone by strengthening 2.6% against the U.S. dollar. This has the effect of reducing the Canadian dollar return on our U.S. equity holdings.[7] Over the last 12 months, the currency is virtually unchanged against the U.S. dollar, so it has had very little impact on the 12-month return.

Canadian Equities

Nexus's Canadian stocks were up 0.5% in the quarter and up a very strong 17.0% over the last 12 months. This was ahead of the TSX Composite's loss of 1.6% in the quarter and well exceeded the index's 11.0% return for the 12 months.

For the quarter, the main positives for our Canadian portfolio were what we *don't own* or that we *own less of* than is in the index. The Energy sector in the TSX had a terrible return of negative 8.3%. Our Energy holdings were weak, but our total energy exposure is quite limited. The Materials sector, where we hold nothing, also did poorly, down 6.4% in the quarter. Our best individual performers were CAE and Allied Properties REIT. CAE continues to exhibit stable, profitable growth in its aircraft simulation and pilot training businesses and Allied Properties has been one of our steadiest performers.

U.S. Equities

Nexus's U.S. equities were up 0.8% in the second quarter and slightly ahead of the S&P 500's return of 0.5%. Over 12 months, our U.S. holdings were very strong, up 26.1% and well exceeded the S&P 500's 17.6% return.

Our financial stocks were our best sector in the quarter, up 7.0% overall. All three holdings, PRA Group, Citigroup and JPMorgan, did well.

During the quarter we established a new position in Dollar General. Dollar General is a dollar store with a 75-year history and a strong presence in the U.S. It now has over 13,500 stores across 44 states. The distinguishing features that attracted us to the stock are:

- it has a well-established track record of profitable growth and operational discipline;
- over 70% of its stores are in small metro areas (fewer than 20,000 people), so it faces limited local competition;
- it has embarked on a substantial new and refurbished store plan;
- it has a strong balance sheet; and
- it is trading at a substantial discount to the S&P 500.

It has a skinny dividend yield, at 1.5%, which is due to its low payout ratio (about 25% of annual profits are paid out as dividends). Management has been doing a good job of deploying the retained earnings.

Other Equity Investments

We continue to hold two non-North American equity investments within our Balanced and Equity Funds. These are externally-managed pooled funds called EQIT (international developed market equities) and EMEC (emerging market equities).[8]

Both funds have continued a strong streak and defied many Eurozone and emerging market sceptics. EQIT was up 4.3% in the most recent quarter and up a very strong 24.2% over the last 12 months. EMEC was up 3.6% in the quarter and up 22.7% for the 12 months. For some time, the overarching global picture was of the U.S. economy pulling the rest of the world along. This has now changed. GDP growth in the Eurozone, U.K. and emerging markets overall is currently ahead of the U.S. Despite the recent run, both international developed markets and emerging markets continue to have better dividend yields and substantially lower valuations than the S&P 500 and TSX Composite. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

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[6] All the return data in the Equities section are total returns for the Equity Fund. Equity returns within the Balanced Fund were similar. For more specific performance, please refer to the Fund reports in this document or your client-specific report.

[7] Except where indicated, all U.S. and international returns are measured in Canadian dollars.

[8] Both funds are managed by teams from JPMorgan Asset Management in London, England.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund generated a total return of 0.8% in the second quarter. This return compares to a loss of 0.6% for the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 19.6%, better than the benchmark return of 13.5%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain at or above the benchmark and are very attractive on an outright basis.

More detail on the Fund's performance is presented in the table below.

In Canada, the equity market fell 1.6% in the quarter. Our Canadian holdings outperformed, delivering a 0.5% return. The main positive contributor to the Fund's relative performance in the second quarter was avoiding the Materials sector, which declined almost 7%. Similarly, the Energy sector of the market declined 8.3% over the same period. Although our energy holdings performed poorly in the quarter, we benefitted from having limited total exposure to this sector.

In the U.S. the equity market gained 0.5% in the quarter. Our U.S. holdings outperformed, generating a 0.8% return. This quarter, our U.S. returns benefitted from our exposure to the Financial sector, with particular contributions from PRA Group and Citigroup. We also benefitted from avoiding the Energy industry in the U.S. However, these positives were partly offset by weak returns in the quarter from a few individual stocks, including GE and Pfizer.

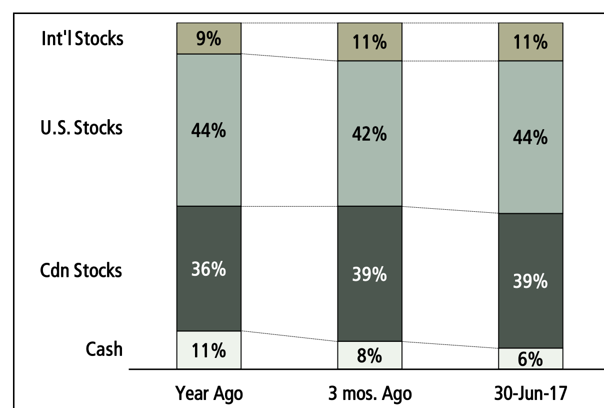
Our international holdings continued their run of strong performance. The developed markets fund, EQIT, was up 4.3% this quarter and the emerging markets fund, EMEC, rose 3.6%.

At the end of the second quarter, the Fund's cash position was 6%. Our allocation to Canadian stocks was 39%, while U.S. stocks represented 44% of the mix. We have maintained an allocation of 11% of the Fund's equity exposure to markets outside North America and remain confident that this will provide important diversification to our North American investments.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	0.8%	0.5%	0.8%	4.0%
Benchmark	*-0.6%*	*-1.6%*	*0.5%*	
One Year				
Fund	19.6%	17.0%	26.1%	23.6%
Benchmark	*13.5%*	*11.0%*	*17.6%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91 Day TBill, 50% TSX, and 45% S&P 500 (in C$) (rebalanced monthly); (b) for Cdn Stocks: TSX; and (c) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at June 30, 2017



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund generated a total return of 0.4% in the second quarter. This return compares to the 0.2% loss for the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 13.3%, better than the benchmark return of 8.7%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain at or above the benchmark and are very attractive on an outright basis.

More detail on the Fund's performance is shown in the table below.

Our bond holdings produced a loss of 0.3% in the quarter, trailing the return of the bond benchmark of 1.1%. The maturity of our bond portfolio remains shorter than the FTSE TMX Universe Bond Index, which led to a negative outcome this quarter, as shorter-term yields rose over the period while longer-term yields declined modestly.

In equities, our Canadian stocks outperformed their benchmark, helped by our avoidance of the Materials sector and relatively limited exposure to the Energy sector. Both these sectors were particularly weak in the quarter. Our U.S. stocks also benefitted by avoiding weakness in the Energy sector and also had positive contributions from PRA Group and Citigroup.

Our international holdings continued their run of strong performance. The developed markets fund, EQIT, was up 4.3% this quarter and the emerging markets fund, EMEC, rose 3.6%.

At the end of the quarter, cash represented 8% of the Fund's asset mix, bonds were 28% and stocks accounted for the remaining 64%. These asset allocations continue to remain close to the Fund's long-term guideline.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	0.4%	-0.3%	0.5%	0.9%	4.0%
Benchmark	*-0.2%*	*1.1%*	*-1.6%*	*0.5%*	
One Year					
Fund	13.3%	0.2%	16.8%	24.6%	23.3%
Benchmark	*8.7%*	*0.0%*	*11.0%*	*17.6%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 91 Day TBill, 30% FTSE TMX Universe Bond, 40% TSX, and 25% S&P 500 (in C$) (rebalanced monthly); (b) for Bonds: FTSE TMX Universe Bond; (c) for Cdn Stocks: TSX; and (d) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at June 30, 2017

	Year Ago	3 mos. Ago	30-Jun-17
Int'l Stocks	6%	7%	8%
U.S. Stocks	35%	33%	31%
Cdn Stocks	25%	26%	25%
Bonds	30%	27%	28%
Cash	4%	7%	8%

Balanced Fund Asset Mix

Nexus North American Income Fund

The Nexus North American Income Fund produced a loss of 0.1% in the second quarter and underperformed relative to the 1.1% total return of the Fund's benchmark during the same period. In the last 12 months, the Fund has returned 3.1%, better than the benchmark return of 0.0%. From a longer-term perspective, our returns for the 2, 3, 5 and 10-year periods remain at or above the benchmark and are very attractive on an outright basis.

More detail on the Fund's performance is displayed in the table below.

Our bond holdings produced a loss of 0.3% in the quarter, underperforming the benchmark which returned 1.1%. This relative underperformance is the result of our maintaining a maturity profile of our bonds that is shorter than the bond benchmark, during a quarter when shorter-term yields rose and the yield curve flattened.

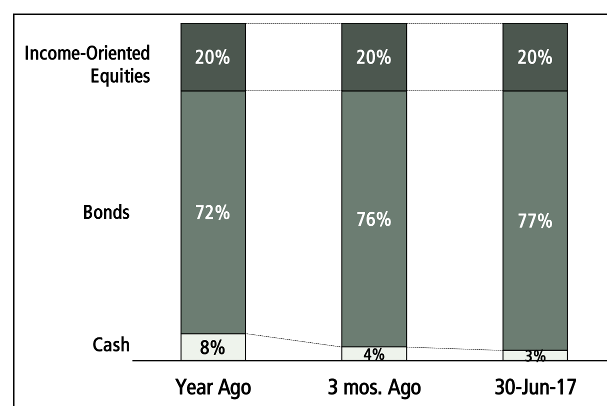
The Fund continued to benefit from tailwinds provided by our Income-Oriented Equities in Canada, although the few U.S. equities we hold were negatively affected by the stronger Canadian dollar.

At the end of the second quarter, the Fund's cash position was 3%, Income-Oriented Equities accounted for 20% and the balance, 77%, was in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-0.1%	-0.3%	1.5%	-2.6%
Benchmark	*1.1%*	*1.1%*		
One Year				
Fund	3.1%	-0.1%	17.0%	15.9%
Benchmark	*0.0%*	*0.0%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: FTSE TMX Universe Bond; (b) for Bonds: FTSE TMX Universe Bond. In addition to bonds, up to 20% of the Fund's portfolio may be invested in equities.

Investment Returns – As at June 30, 2017



Income Fund Asset Mix

Nexus International Equity Fund

The Nexus International Equity Fund ("NIEF") holds two underlying funds: EQIT (invested in international developed market equities) and EMEC (invested in emerging market equities).[9] In the second quarter, NIEF had a very good return of 4.0% and was slightly ahead of its blended benchmark return of 3.5%. Both EQIT (up 4.3%) and EMEC (up 3.6%) did well. Over the past year, EQIT returned 24.2% and EMEC 22.7%.

The news flow for international developed markets continues to improve. Eurozone real GDP growth in the first quarter, at 2.3%, is improving and ahead of the U.S. Unemployment continues to decline and loan growth (a sign of confidence in the outlook) continues. In the same period Japan's real GDP growth, at 1.3%, is above its long-term average and in line with the U.S. for the same quarter. For emerging markets overall, GDP growth continues to be faster than that of the developed world and the gap is widening. The emerging markets weak currency penalty that we mentioned last quarter (which has reduced emerging market companies' earnings growth as measured in U.S. dollars and reduced emerging markets stock market returns when measured in the U.S. currency) has continued to improve since early 2016. If emerging market currencies strengthen over time, this will be a direct add-on to the investment return that foreign investors receive.

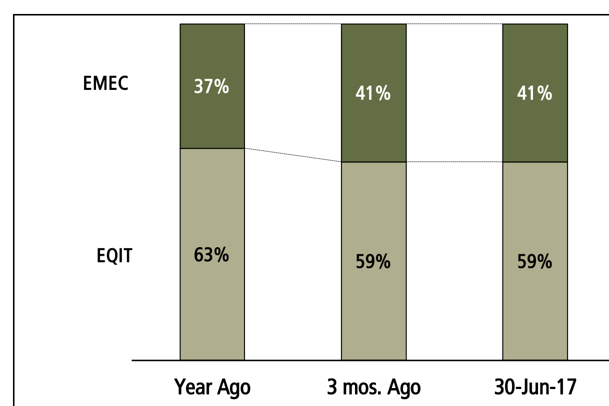
Indeed, the broader story may be that the long period of a strong U.S. dollar may be waning. Its currency was relatively strong in the credit crisis and while the U.S. was the main engine of global economic growth in the years that followed. This strength continued when the U.S. Federal Reserve was the first major central bank to raise short-term interest rates. Now non-U.S. growth is better, other key central banks are musing about raising rates (the U.K., the European Central Bank, and even Canada) and the new U.S. administration has come out in favour of a weaker U.S. currency. As a result, in the first six months of 2017, even with the stronger Canadian dollar against the U.S. dollar, our currency weakened against the other international developed market currencies, which served to add to the Canadian-dollar return from EQIT. The currency was flat with the basket of emerging markets currencies, so the return of EMEC, whether measured in native currencies or our currency, was the same. Finally, as a general point, the correlation between U.S. and other international countries' equity markets has declined since 2009 and is the lowest it has been since 2004. Both these points serve to underline the benefit of some non-North American diversification for investors.

The Nexus International Equity Fund is overweight emerging markets relative to international developed markets. The Fund's proportional exposure of developed markets to emerging markets is now about 60:40, whereas the Fund's benchmark is 75:25. For the past few years, our emerging markets overweight has helped to add value relative to the benchmark. While we expect this positioning to help over the long term, it will not always be the case each quarter or year.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	4.0%	4.3%	3.6%
Benchmark	*3.5%*	*3.5%*	*3.6%*
One Year			
Fund	23.7%	24.2%	22.7%
Benchmark	*20.9%*	*20.0%*	*23.4%*

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: 75% MSCI EAFE (in C$) and 25% MSCI Emerging Mkts (in C$) (rebalanced monthly); (b) for EQIT: MSCI EAFE (in C$); and (c) for EMEC: MSCI Emerging Mkts (in C$).

Investment Returns – As at June 30, 2017



International Equity Fund Asset Mix

[9] International developed markets or EAFE includes Europe, Australasia and the Far East. Emerging markets include 23 developing countries. EQIT and EMEC are managed by JPMorgan Asset Management in the UK. The Nexus Balanced and Equity Funds have held EQIT and EMEC for some time and continue to do so.